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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
)
Implementation of Sections of the)
Cable Television Consumer)
Protection and Competition Act of)
1992: Rate Regulation)

MM Docket No. 93-215

COMMENTS OF VIACOM INTERNATIONAL INC.

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SUMMARY

The Commission has appropriately recognized that, however great its commitment to the benchmark/price cap mechanism as its primary approach, it would ignore its constitutional and statutory mandate were it not to incorporate a cost-based approach at least as a backstop in its comprehensive scheme for cable rate regulation. This backstop -- and in turn the constitutional sustainability of Commission rate regulation overall -- would fall, however, were the Commission's cost-of-service standards not fairly designed to ensure recovery of all cable operator costs, including a cost of capital.

The Commission's crafting of cost-of-service standards should be guided by two core principles, each of which is embodied in the NPRM and seeks to serve the interests of the industry and consumers alike. First, cost-of-service regulation must seek to replicate rates as they would exist under competitive conditions. Second, the Commission's regulatory scheme must ensure an orderly and fair transition to rate regulation.

The Commission's proposed "original cost" approach to initial valuation of cable rate base, however, is ill-suited to serving these principles -- as a matter of law, policy, and economics. The NPRM's proposed application of "original cost" is at odds with long established public utility law, as well as the FCC's own precedent. Further, the proposed

categorical exclusion of acquisition premiums from the rate base, which is grounded in this misapplication of "original cost" methodology, would amount to an unconstitutional confiscation. Beyond these legal infirmities, moreover, the proposed valuation methodology is economically unsound and will not produce rates replicating those of a growing industry in a competitive environment, as demonstrated in the attached economic study by Kolbe and Vitka of the Brattle Group.

Based on the Kolbe/Vitka Study, Viacom recommends that the FCC adopt an alternative rate base valuation methodology: competitive market value. Under this approach, cable asset value is measured by its actual market value and then reduced by the amount of quantifiable capitalized monopoly rents. This approach would lead to rates similar to those produced in a competitive environment by enabling the Commission to disallow any monopoly profits -- yet, unlike the "original cost" approach, it does so in an economically rational manner.

Once operators' initial rate bases are set at competitive market values, the Commission should value the assets on a going-forward basis by using "trended original cost" to replicate the workings of a competitive market. As the Kolbe/Vitka Study indicates, the traditional, untrended historical cost approach erroneously assumes that prices in a competitive market vary with the age of assets,

and thus that approach produces cyclical rates that fail to track those of a competitive environment.

Building on these valuation methodologies that seek to replicate competition, Viacom proposes a carefully tailored blend of industry-wide and company-specific factors for completing the calculation of a cable system's revenue requirement. The Commission should recognize the substantial risk in the cable industry and accordingly set a uniform, industry-wide rate of return at approximately 16 percent. The Commission should also allow depreciation of cable assets and aggregation of costs on a system-wide basis. In addition, the Commission should ensure that cost allocation and accounting rules are both simple to apply and do not rely on channels or other allocations that will lose their meaning with the advent of the digital era in the cable industry. Together, these proposals offer a rational, administratively feasible package of streamlined cost-of-service standards.

Viacom also addresses two additional issues raised in the cost-of-service NPRM. First, Viacom questions the necessity of affiliate transaction rules, but endorses the Commission's proposed formulation of such rules should they be deemed necessary. Viacom, in fact, advocates adoption of the NPRM's proposed marketplace approach to determining the ability of cable operators, under the benchmark/price cap mechanism, to "pass through" increases in the cost of programming obtained from affiliated entities. Finally,

Viacom demonstrates the redundancy and inappropriateness of adopting a productivity factor to offset price cap adjustments for rates calculated under the Commission's benchmark mechanism.

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COMMENTS OF VIACOM INTERNATIONAL INC.

Viacom International Inc. ("Viacom"),¹ by its attorneys,
hereby submits its comments on the Commission's proposed
framework for cost-of-service regulation of cable rates.²
Viacom proposes a comprehensive approach for determining a
cable system's revenue requirement, relying first on a
market-based valuation of the rate base and then on a series

¹ Viacom owns and operates cable systems serving approximately 1,100,000 subscribers. Showtime Networks Inc. ("SNI"), a wholly-owned subsidiary of Viacom, owns and operates the premium program services Showtime, The Movie Channel, and FLIX. MTV Networks ("MTVN"), a division of Viacom, owns and operates the advertiser-supported program services MTV: Music Television, VH1/Video Hits One, and Nickelodeon (comprised of the Nickelodeon and Nick at Nite programming blocks). Viacom also owns Showtime Satellite Networks Inc., which distributes SNI, MTVN and third-party program services to owners of home television receive-only earth stations nationwide. Through wholly-owned subsidiaries, Viacom holds partnership interests in Comedy Central, Lifetime Television and All News Channel, advertiser-supported program services, and in Prime Sports Northwest, a regional sports service in the Seattle-Tacoma, Washington area.

² Notice of Proposed Rulemaking, MM Docket No. 93-215, FCC 93-353 (released July 16, 1993) ("Cost-of-Service NPRM" or "NPRM").

of methods for streamlining the traditional cost-of-service process.

This approach balances the interests of consumers and cable operators by adhering faithfully to the fundamental congressional mandate for cable rate regulation: replicate rates and returns as they would exist under competition. Ensuring operators no more and no less than a fair return on their legitimate investment, this approach preserves cable operators' ability to secure funding in the capital markets for system upgrades, the introduction of innovative programming, and other investments accruing to the benefit of consumers. Viacom's approach is also rooted in what Viacom believes must be a core principle of any successful cable regulation program: provide the industry and consumers with an orderly and constructive transition to regulation. Viacom's proposal therefore combines a competitive market-based valuation of the rate base with a transitional approach allowing for a change from an unregulated to a regulated environment. Its proposed streamlined package serves, as well, the shared interests of regulator and regulatee in helping to ensure an administratively feasible and efficient mechanism for cost-of-service showings.

Viacom addresses two other specific issues raised in the Cost-Of-Service NPRM. First, Viacom generally endorses the NPRM's proposed formulation of affiliate transactions rules

should the Commission determine that, even absent a history of abuses, such rules are necessary for cost-of-service showings. Indeed, Viacom recommends a similar marketplace test for passing through increases in affiliated programming costs under the Commission's price cap mechanism. Second, Viacom urges the Commission to recognize the redundancy and inappropriateness of adopting a productivity factor to offset price cap adjustments for rates calculated under the benchmark approach.

I. THE SUCCESS OF THE COMMISSION'S OVERALL APPROACH TO CABLE RATE REGULATION DEPENDS ON ITS CRAFTING COST-OF-SERVICE STANDARDS THAT DRIVE RATES TO FULLY COMPETITIVE LEVELS WHILE STILL PERMITTING AN ORDERLY TRANSITION TO REGULATION

A. The Commission Has Delegated To Its Cost-Of-Service Standards The Constitutional And Statutory Duty To Ensure That Rate Regulation Allows Cable Operators To Recover Their Costs

The Cost-of-Service NPRM clearly reflects the Commission's recognition that, however great its commitment to benchmarks/price caps as its primary approach, a cost-based approach is a necessary and critical component of its comprehensive scheme for cable rate regulation. The Commission has contemplated a two-pronged approach from the start, tentatively concluding in its initial rate regulation proposals "that cost-of-service regulatory principles could have a secondary role for cable operators seeking to justify

the reasonableness of rates that do not meet our primary benchmarking standard."³

This alternative method of justifying rates is necessary because the Commission's benchmarks do not -- and do not purport to -- take costs into consideration.⁴ Moreover, as the Commission readily noted, "the starting price cap level is based on industry-wide data and does not necessarily reflect individual systems' cost of providing cable service." Id. at 803. The Commission thus acknowledged the limits of a benchmark/price cap mechanism based, as it is, not on individual costs, but rather on average prices:

[W]e cannot be certain that the initial capped rate defined through benchmark comparisons will permit all cable operators to fully recover the cost of providing basic tier service and to continue to attract capital. Accordingly, we believe that it is acceptable to permit cable operators to exceed the capped rate if they can make the necessary cost showings in certain circumstances.

Id. The Commission thus assigned to its cost-of-service approach this critical task of evaluating whether rates that exceed the benchmarks are nonetheless reasonable in light of a system's permissible costs. Cost-of-Service NPRM at ¶ 10.

³ Implementation of the Cable Television Consumer Protection and Competition Act, 8 FCC Rcd 510, 519 (1992) (Notice of Proposed Rulemaking, MM Docket 92-266).

⁴ See Implementation of the Cable Television Consumer Protection and Competition Act, 72 Rad Reg.2d (P&F) 733, 746-747 n.29 (1993) (Report and Order) ("Benchmark Order").

This cost-based component of the Commission's regulatory regime is firmly rooted in the express requirements of the Cable Act of 1992.⁵ While mandating regulation of cable rates, the Cable Act of 1992 also unambiguously mandates that the standards for regulating cable rates take due account of all costs. The Act expressly requires that, in prescribing rate regulations, the Commission "shall take into account" the litany of costs incurred in providing cable service,⁶ including the cost of capital or, as expressed by the Act, a reasonable profit.⁷ As the Commission therefore stated, "We

⁵ Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, 106 Stat. 1460 (1992) ("Cable Act of 1992" or "Act").

⁶ See 47 U.S.C. § 543(b)(2)(c) (emphasis added). The Act expressly notes each of the following costs of providing basic cable service: the direct costs, as well as the portion of joint and common costs, reasonably and properly allocable to obtaining, transmitting, and otherwise providing signals carried on the basic tier, and changes in such cost; the reasonably and properly allocable portion of franchise fees, taxes, or other governmental assessments; the costs of satisfying franchise requirements; and the capital and operating costs of the cable system. See id. at §§ 543(b)(2)(C)(ii, iii, v, and vi), 543(c)(2)(E).

⁷ As the Benchmark Order states (at 803):

In order to assure that our framework for regulation of rates of the basic service tier will take this [reasonable profit] statutory factor into account, we established that in any cost-of-service proceeding rates must be set to allow cable operators to earn a reasonable profit for provision of cable service.

See 47 U.S.C. § 543(b)(2)(C)(vii).

do not believe that Congress intended that cable operators could, or should, be compelled to provide basic [] tier service at rates that do not recover such costs." Benchmark Order at 803.

The Constitution, of course, would not permit such a result. See Section II(A)(3), infra. Indeed, the Commission has explicitly recognized that this cost-based "backstop" is the linchpin in the asserted constitutionality of the Commission's overall regulatory scheme. See, e.g., Memorandum Opinion and Order Further Notice of Proposed Rulemaking, MM Docket No. 92-266, FCC 93-389 at ¶ 15 (released August 10, 1993).

Furthermore, the plain fact is that consumers do not benefit when cable operators are unable to cover their costs and cannot attract new capital at reasonable rates. Absent that capability, operators simply would not be able to sustain their existing level of service, much less continue to provide an ever greater quantity and quality of service. As the Commission expressed it, "[a]n overly tight cap on rates could hinder cable operators' ability to make network improvements that could benefit subscribers." Benchmark Order at 803.

A proper balancing of operator and consumer interests is essential, therefore, to fulfilling the Commission's enunciated goal that its "regulatory requirements for cost-

based rates should also be designed to assure that cable operators may fully respond to incentives to provide a modern communications infrastructure and to respond to competitive forces." Cost-of-Service NPRM at ¶ 9.⁸ Cost-of-service standards that strain to suppress cable rates inevitably will "thwart operators' ability to respond to competitive forces by means of facility and service improvements." Id.

The Commission thus clearly accepts the principle that its cost-of-service standards must allow cable operators to recover their total costs. Cost-of-service showings cannot, therefore, be governed by rules so result-oriented and unavailing as to ensure that they will never, or only rarely, be used. The Commission must recognize that these showings do not amount to an unwarranted circumvention of benchmarks or an inappropriate windfall for cable operators. To the contrary, the Commission would disserve the Act, the Constitution, and the public interest if it were to skew its cost-of-service standards so as to effectively force operators to submit to a noncompensatory benchmark approach.

⁸ As the Commission noted, the Act itself identified the policy goal of "ensur[ing] that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems." Cable Act of 1992, § 2(b)(3), cited in Cost-of-Service NPRM at ¶ 9.

B. The Commission Should Adopt Standards For
Cost-Based Ratemaking That Seek To
Replicate The Competitive Environment And
Ensure A Fair, Orderly Transition To Rate
Regulation

Viacom respectfully submits that the Commission will find the greatest success in striking the constitutionally-required balance of interests and in achieving the important national goals described above if its cost-of-service approach adheres faithfully to two core principles, each of which is firmly embodied in the NPRM itself. First, regulation should seek to replicate rates as they would exist in a fully competitive environment. Second, any successful regulatory scheme must be tailored to the unique characteristics of the industry to be regulated. Critical to this second principle is recognition by the Commission of the cable industry's impending transition to a rate regulated environment.⁹ If the Commission can craft cost-of-service regulations that drive cable rates to fully competitive levels while still permitting an orderly transition to regulation, it will have fulfilled its mandate under the

⁹ The scope of this transformation cannot be overstated. Cable operators, large and small alike, are in a short time being required to change every facet of their business. New rates for program services and equipment, new rate structures, new customer service requirements, and new accounting requirements are only some of the changes being visited on the cable industry. This is occurring, moreover, just as the industry is preparing to move into a more competitive, digital world.

Cable Act of 1992 without sacrificing its broader duty to serve as well the Constitution and the public interest.

1. The Commission Can Best Ensure Cable Operators Recovery Of Their Costs, While Still Protecting Consumers Against Excessive Rates, By Designing Its Cost-of-Service Standards To Replicate Competition

Rate regulation exists to cure perceived market failures, that is, the absence of competitive forces adequate to drive rates to a level that provides for the recovery of costs and an appropriate return on those costs. It is thus a matter of first principles that rate regulation, and cost-of-service regulation in particular, should seek to replicate rates as they would exist in a competitive market.

The Act describes the "Commission Obligation to Subscribers" just this way:

[R]egulations shall be designed to achieve the goal of protecting subscribers of any cable system that is not subject to effective competition from rates for the basic service tier that exceed the rates that would be charged for the basic service tier if such cable system were subject to effective competition.

47 U.S.C. § 543(b)(1).¹⁰ Viacom thus responds with an

¹⁰ This was precisely the theory underlying the Commission's benchmark scheme: the Commission determined that the benchmarking process for setting rates would be
(continued...)

emphatic "yes" to the Commission's query of "whether our regulatory framework for cost-based rates should also be guided by the goal of producing rates that approximate competitive rate levels, i.e., rates that approach the operators' costs." See Cost-of-Service NPRM at ¶ 10.

The Commission's clear understanding of the purpose of rate regulation, and cost-of-service rate regulation in particular, should enable the Commission to readily answer the NPRM's question regarding "what rate levels our cost-based requirements should produce in relation to benchmark rates." Id. at ¶ 7. The cost-based alternative to benchmarks is, of course, premised entirely on the need for

¹⁰(...continued)
based on the goal of achieving rates for cable service that approach rates of competitive systems. Cost-of-Service NPRM at ¶ 10. The Commission sought to establish a reliable differential between the rates charged by systems facing "effective competition" and those that did not. Benchmark Order at 746-747 & n.29, app. E. The Commission then sought to require a reduction in the rates charged by cable systems not facing "effective competition" either to benchmark levels or otherwise in the amount of that differential (10 percent). Id.

Viacom has taken issue with the Commission as to whether it has in fact accomplished this goal. In seeking reconsideration of the Commission's benchmark approach, Viacom has submitted that the surveyed rates upon which the benchmarks rely were in fact not the fully compensatory, sustainable rates of a competitive equilibrium, nor in other respects representative of the cable industry. See Viacom Petition for Reconsideration and Clarification, MM Docket No. 92-266 (filed June 21, 1993), and the study appended thereto. However, Viacom does not take issue with the analytical premise of the Commission's benchmark approach, i.e., seeking to replicate competitive rates.

operators to have a mechanism for justifying rates that exceed the benchmarks. Thus, it would be incongruous, and would render the cost-of-service alternative meaningless, were the Commission to seek to drive the results of cost-based showings back toward benchmark levels.¹¹

2. Cost-Of-Service Standards Imposed
Upon The Cable Industry Without
Regard For Its Preexisting Financial
Practices And Structure Will
Undermine Both The Industry's
Financial Stability And The
Objectives Of The Cable Act Of 1992

From its experiences in the common carrier arena, the Commission is well aware that crafting cost-of-service standards that replicate competition is difficult even for an industry long subject to rate regulation. This task is substantially complicated here, however, by the fact that this regulatory apparatus is being imposed on a cable industry whose rates -- and whose financial activities in general -- were previously unregulated. The issue is not simply how to value assets in a rate base, but rather the more difficult question of how to initially value assets when bringing an industry under regulation. Viacom respectfully submits that the core principle which must guide the

¹¹ If the rates produced by one of these two mechanisms are to be adjusted, it would only make sense that the price-based benchmark matrix be adjusted.

Commission's imposition of cable rate regulation is the critical need for a successful transition from a non-regulated to a regulated environment. While the fact of this transition is obvious, some of its implications may not be.

It is most unusual, if not unprecedented, to see an industry so swiftly and dramatically ripped from its past financial moorings. The Commission recognizes as much in calling for proposals that include "explicit transition elements addressing the changes in financial practices and structure required by cable operators as they adapt to a rate regulated environment." Cost-of-Service NPRM at ¶ 22. The Commission has acknowledged that its proposed requirements "governing costs may constitute different costing, accounting, and financial practices for purposes of setting rates than current practices in the cable industry." Id.

Cost-of-service requirements, however, do much more than just saddle the industry with entirely new bookkeeping burdens. They will, in many cases, also require an operator to restructure its financial arrangements and perhaps jeopardize its existing debt covenants.¹² The Commission

¹² Significantly, the Commission recognized that its standards "may also represent a different measure of industry performance than currently used by the cable industry and lenders." Cost-of-Service NPRM at ¶ 22. In the past, a creditor's evaluation of a cable system's financial status, and the contractual requirements in loan agreements and indentures arising from and intended to ensure the integrity of that status, were based on a number of factors which were
(continued...)

acknowledges this in exploring how to treat, as a regulatory matter, the costs incurred by companies in acquiring systems prior to this current transition from a non-regulated to a regulated environment. Id. at ¶ 39, n.44.

The Commission appropriately states in this regard that "[a]n important determinant of the standards that we adopt will be the impact on the industry and consumers." Id. at ¶ 22. The real costs assumed by the cable industry prior to regulation will not simply disappear with the stroke of a subsequent regulatory wand. If these real costs are not accounted for and cost-of-service standards thus leave cable operators just as unable to cover their costs as do the benchmarks, substantial segments of the cable industry will indeed suffer severe dislocation in the form of defaulted loans and resulting foreclosures; the impact will be felt not only by cable operators and their subscribers, but by lending institutions as well, including in particular the commercial banking community. And the link between financial soundness

¹²(...continued)
extraneous to a regulatory analysis and did not account for regulatory impediments. To the extent that regulations cause preexisting cash, operating and profit assumptions to be undermined, existing financial arrangements between cable systems and lenders based on coverage ratios and similar indicia of financial integrity will come under pressure from cable's rapid immersion into regulation. How these agreements -- and in turn the financial stability of cable systems -- would be affected by a given regulatory proposal, especially one demanding immediate financial change, must be an integral factor in the Commission's public interest calculus.

and the quality of cable service is, as the NPRM recognizes, a direct one. See id. at ¶ 54.

The Commission thus wisely looks for appropriate lessons in the experiences of other federal regulatory agencies, such as the Federal Energy Regulatory Commission, that "have established a balancing of consumer and regulated company interests that explicitly recognizes a transition [from] an unregulated to a regulated environment." Cost-of-Service NPRM at n.21. Viacom believes that there is indeed much to be learned from other regulators' experiences. Indeed, Viacom's proposals for how the FCC should establish the starting point in valuation of a cable system's assets and how it should treat the rate base from that point forward draw in part from the actions of other federal agencies.

II. THE COMMISSION SHOULD DETERMINE A CABLE SYSTEM'S INITIAL RATE BASE BY FOCUSING ON COMPETITIVE MARKET VALUES, NOT IRRELEVANT HISTORICAL COSTS

Nowhere is it more important that the Commission adhere to the two core principles of (i) replicating competition and (ii) permitting an orderly transition to regulation than in establishing the standards for the initial valuation of cable systems' rate base. The prior unregulated status of the cable industry renders unsound the NPRM's proposed

application of "original cost" methodology.¹³ The quest to replicate rates as they would exist in a competitive marketplace leads directly to the more appropriate valuation methodology proposed below -- a competitive current market value approach. This approach is free of the systematic undervaluation of cable systems which would result from a pure "historical cost of physical assets" calculation of the rate base. It also avoids the potential inclusion of capitalized monopoly rents which could result from an unrefined acquisition cost-based calculation of the rate base.

A. The NPRM Misapplies "Original Cost"
Methodology And Its Underlying Rationale
In Proposing To Value The Assets In The
Rate Base Of Cable Systems By Using The
Initial Cost of Construction

The NPRM appears to suggest that cable rate bases can be determined based on the original or historical cost of the assets, regardless of when such costs were initially

¹³ While the NPRM contemplates the use of historical costs to value cable assets, as is traditionally done with public utilities, it is important to recognize that this is not mandated by law. In fact, the Cable Act of 1984 made clear that Congress did not then perceive the cable industry as a public utility: "any cable system shall not be subject to regulation as a common carrier or utility by reason of providing any cable service." See 47 U.S.C. § 541(c). Indeed, even the Cable Act of 1992 did not intend for the cable industry to become subject to the full scope of utility-type regulation embodied within Title II of the Communications Act. See H.R. Rep. No. 628, 102d Cong., 2d Sess. 30 (1992) ("House Report"); Benchmark Order at ¶ 8.

incurred.¹⁴ Cost-of-Service NPRM at ¶ 33 n.36. Viacom respectfully suggests that this proposed determination of original cost is founded on the incorrect presumption that cable has always been subject to a pervasive regulatory scheme. Even if this presumption were not an historical fiction, however, this wooden application of original cost methodology would totally ignore critical transition issues raised in subjecting the cable industry to this new, comprehensive scheme of rate regulation. As a result, the NPRM's proposed approach to establishing cable rate bases would unfairly penalize those cable operators who legitimately purchased cable systems after they were built and established as ongoing businesses and, thus, would create havoc for the industry and the viewers it serves.

1. The NPRM's Approach Is Contrary
To Established Public Utility
Law As Applied By The FCC
And Other Regulators

Public utility law has long established that the "original cost" of assets is normally set at the time those assets are first dedicated to the public use. The Commission has relied on this definition of original cost ever since first instituting its Uniform System of Accounts ("USOA") in

¹⁴ All costs associated with those assets and incurred beyond that date would apparently be placed in an "excess acquisition" account. See Cost-of-Service NPRM at ¶¶ 36-41.